No. 12,117

IN THE

United States Court of Appeals

For the Ninth Circuit

SOUTHERN PACIFIC COMPANY, a corporation,

Appellant,

vs.

HAROLD BERLINER, Former Collector of Internal Revenue for the First Collection District of California,

Appellee.

BRIEF FOR APPELLANT

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STATEMENT AS TO JURISDICTION

This appeal has been taken by appellant (styled "plaintiff" in the Court below) from a judgment rendered by the District Court of the United States for the Northern District of California, Southern Division, in an action commenced in that Court by Southern Pacific Company, a

Kentucky corporation, (hereinafter referred to as "the Old Company") to recover stamp taxes (Tr. 3). Appellant, a Delaware corportion, is the assignee of the Old Company, having succeeded to all its business and assets under a Plan of Reincorporation involving a mere change in the state of incorporation, and was substituted as plaintiff in this action in place of the Old Company by order of the District Court on October 20, 1947 (Tr. 46-48).

The taxes involved were assessed under Sections 1800 and 1802(a) of the Internal Revenue Code (Tr. 3). Consequently, the District Court had jurisdiction of this action under Section 41(5) of Title 28, United States Code, which gives the District Courts of the United States jurisdiction "of all cases arising under any law providing for internal revenue * * *."

The District Court also had jurisdiction of this action under Section 41(1), subdivisions (a) and (b), of Title 28, United States Code, in that this is a suit of a civil nature, at common law, arising under the Constitution or laws of the United States, in which the matter in controversy, exclusive of interest and costs, exceeds $3,000 and in which plaintiff (appellant) and defendant (appellee) are residents of different states (Tr. 2, 48).

After trial of the issues raised by the pleadings, the District Court on October 29, 1948, rendered judgment (Tr. 81-82) in favor of defendant (appellee). By notice filed November 26, 1948 (Tr. 82), this appeal was taken from the judgment. The jurisdiction of this Court is invoked under Section 225(a), First, of Title 28, United States Code.

STATEMENT OF THE CASE

This action is brought to recover stamp taxes amounting to $46,687.95, with interest as provided by law from February 26, 1943, the date of payment. These taxes were paid under protest to appellee (styled "defendant" in the Court below) in his official capacity as Collector of Internal Revenue for the First Collection District of California (Tr. 6) upon an assessment of shares of no-par value stock issued by the Old Company in place and stead of its outstanding par value stock. This action is maintained upon the basis that the assessment was void because the stock taxed was not an original issue but an exchange of stock for an original issue, theretofore issued and outstanding. The appeal is taken upon the judgment roll, and the assignments of error are based on the contention that the facts do not support the conclusions of law.

The facts were stipulated (Tr. 49-71).

The Old Company, on April 23, 1940, had outstanding 3,772,763.0564 shares of capital stock having a par value of $100 a share, of which 3,562,606.0564 shares were issued at par and 210,157 shares were issued at a premium of $6,304,845 over par. A substantial part of said stock was issued during periods when federal stamp taxes on the issuance of capital stock were in effect, and on all such parts of its outstanding capital stock the Old Company duly paid the federal stamp taxes then in effect (Tr. 50, Stip. 4). On that date, April 23, 1940, the Old Company, pursuant to an amendment of its charter (Tr. 52-54, Stip. 7), issued in exchange for its then outstanding par value stock an identical number of shares of no-par value stock. The no-par value shares were issued to the holders of the

par value shares and to no others, in exchange for the shares then held (Tr. 50-51, Stip. 5-6). In connection with said amendment and the issuance and exchange of said no-par value stock, no new money was paid in and no property was transferred to the Old Company (Tr. 51, Stip. 5; Tr. 61, Stip. 12). The only change was the transfer of the $6,304,845 premium on capital stock from one subaccount to another subaccount (Tr. 64-65, Stip. 15).

The Old Company was subject to the accounting regulations of the Interstate Commerce Commission.[1] It was required to comply with the procedure prescribed by the Commission concerning the forms of balance sheets and annual reports. At the time of the above exchange of stock, the Commission's regulations and forms provided for two subaccounts which, when added together, made up the item entitled "Total Stock." These were Subaccounts 751 and 753, respectively entitled "Capital Stock" and "Premium on Capital Stock." Under the Commission's regulations, when a railroad company had outstanding capital stock of a stated par value which had been issued at a premium, it was required to set forth such capital in two subaccounts as follows: (a) the par value in Subaccount 751, entitled "Capital Stock," and (b) the premium in Subaccount 753, entitled "Premium on Capital Stock." The sum of these two made up the item entitled "Total Stock."

The Commission's regulations further required that, when stock having par value was exchanged for stock without par value, sums carried in the premium Subac-

1. These accounting regulations are judicially noticed. *Lilly v. Grand Trunk Railroad Co.,* 317 U.S. 481, 488; *Caha v. United States,* 152 U.S. 211, 221-222.

count 753 for the class of stock retired be cleared to "Capital Stock" Subaccount 751.

Pursuant to these regulations, the stock account of the Old Company prior to the above exchange was set forth as follows in its balance sheets and in its annual reports to the Commission (Tr. 61-62, Stip. 13) (except that in the annual reports figures in cents were not shown):

"STOCK

751	Capital Stock	$377,276,305.64
753	Premium on Capital Stock	6,304,845.00
	Total Stock	$383,581,150.64"

After the exchange of no-par value stock for par value stock, the accounts of the Old Company were identical with what they had been immediately prior thereto, except that, pursuant to the requirements of the Interstate Commerce Commission, the amounts in the two subaccounts of the stock account were merged and the total of the two, $383,581,150.64, was placed in "Capital Stock" Subaccount 751. Subsequent to the exchange, the Old Company's stock account, as shown in its balance sheets and in its annual reports to the Commission, was carried as follows (Tr. 64, Stip. 15) (except that in the annual reports figures in cents were not shown):

"STOCK

751	Capital Stock	$383,581,150.64
753	Premium on Capital Stock	—
	Total Stock	$383,581,150.64"

There was no change in the Old Company's surplus account, no change in the number of its shares outstanding, and no change in its "Total Stock" account (Tr.

64-65, Stip. 15). The only change was the transfer to the "Capital Stock" Subaccount 751 of the $6,304,845 theretofore carried in the premium subaccount and which previously had been realized by the Old Company upon the issuance of tax-paid or tax-free certificates of stock (Tr. 62-65, Stips. 14-15).

The "Premium on Capital Stock" of $6,304,845 represented the excess over par received by the Old Company upon the issuance of 210,157 shares of its capital stock in the following circumstances (Tr. 62-64, Stip. 14):

In 1909 certain bonds were issued by the Old Company which gave the holders thereof the privilege of converting their bonds into paid-up shares of common stock of the Old Company at the rate of $130 par value of bonds for each $100 par value of stock on or before June 1, 1919. Up to January 9, 1912, $662,090 par value of the said bonds were surrendered and $509,300 par value of stock was issued in place thereof, i.e., bonds of a par value of $662,090 were exchanged or paid for 5,093 shares of the capital stock of the Old Company having a par value of $100 per share. The excess of the par value of the bonds over the par value of the stock, namely, $152,790, was entered in the Premium on Capital Stock Subaccount. There was no law taxing the original issue of certificates of stock when this conversion was made, so that no tax was payable on the original issue of the 5,093 shares.

In 1919 bonds of a par value of $26,657,150 were turned in and the Old Company issued in place thereof 205,055 shares of capital stock, each share having a par value of $100 (total par value, $20,505,500). The excess of the par value of the bonds over the par value of the stock, namely,

$6,151,650, was credited to the Premium on Capital Stock Subaccount. The proper amount of stamp tax was paid upon the issuance of the shares of stock issued on the exchange, numbering 205,055 shares.

The remaining $405 of the $6,304,845 premium item came about in the following manner: In 1929 the Old Company issued certain bonds which had warrants attached thereto entitling the owners thereof to purchase on or before May 1, 1934, three shares of the Old Company's $100 par value stock at $145 per share, plus adjustment of accrued dividends. A total of nine shares of the Old Company's stock was purchased pursuant to this arrangement in 1930 for a total price of $1,305. The excess of $405 over par was credited to the Premium on Capital Stock Subaccount. Stamp tax was paid with respect to these shares.

The Commissioner of Internal Revenue determined that the transfer of the amount previously listed as "Premium on Capital Stock" to the Capital Stock Subaccount resulted in additional capital being dedicated to the Capital Account (Tr. 39); that this represented capital upon which no previous issue tax had ever been paid; that the new capital and the old capital were so intermingled that it was impossible to allocate to the new capital any of the no-par value shares, and that, as a result, the entire issue of no-par value stock was subject to the stamp tax as an original issue under Section 1802(a) of the Internal Revenue Code. The tax was paid under protest, and claim for refund was denied (Tr. 35-39).

Following denial of the refund claim, this action was commenced on February 9, 1946. In Memorandum Decision and Opinion dated July 16, 1948 (Tr. 72-77), the

District Court sustained the determination of the Commissioner.

The District Court found as facts (1) that the amount of $6,304,845 transferred from "Premium on Capital Stock" to "Capital Stock" was additional capital[2] (Finding No. 6, Tr. 79), and (2) that, when the amount of $6,304,845 was transferred to the Capital Stock Account and new shares issued, each share represented both old and new capital (Finding No. 7, Tr. 79).

The District Court concluded (1) that, upon the issuance of the 3,772,763.0564 shares of no-par value stock in exchange for the like number of outstanding shares of $100 par value stock, an original issue tax was incurred under the provisions of Sections 1800 and 1802(a) of the Internal Revenue Code,[3] as amended, because of the addi-

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2. If this finding had been made upon disputed evidence it would be binding upon appeal, unless clearly erroneous.—Rule 52, Rules of Civil Procedure. This finding, however, is based upon a stipulation of facts, and no such persuasive effect is to be given to it. In truth, this finding is no more than a conclusion of law from the undisputed facts, and findings which are conclusions of law rather than findings of fact are not protected by rule 52(a).—*Himmel Bros. Co. v. Serrick Corp.* (C.C.A. 7), 122 F.(2d) 740, 742.

3. Sec. 1800. Imposition of Tax.

There shall be levied, collected, and paid, for and in respect to the several bonds, debentures, or certificates of stock * * * and things mentioned and described in sections 1801 to 1807, inclusive, * * * (26 U.S.C. 1940 ed., Sec. 1800.)

Sec. 1802 (as amended by Revenue Act of 1939, c. 247, 53 Stat. 862, Sec. 1). Capital Stock (and Similar Interests).

(a) Original Issue.—On each original issue, whether on organization or reorganization, of shares or certificates of stock, * * * on each $100 of par or face value or fraction thereof of the certificates issued by such corporation, * * * 10 cents; provided, that where such shares or certificates are issued without par or face value, the tax shall be 10 cents per share * * *, unless the actual value is in excess of $100 per share; in which case the tax

tion of the amount of the $6,304,845 to the Capital Stock Account without any allocation of specific shares to such transferred amount (Concl. No. 1, Tr. 79), and (2) that appellant is not entitled to recover in this action (Concl. of Law No. 2, Tr. 80). On October 29, 1948, judgment was entered against appellant (Tr. 81-82), and this is an appeal from that judgment.

The questions involved are:

(a) Whether, under the facts as stipulated, the District Court should have held, as a matter of law, that the 3,772,763.0564 shares of no-par value stock issued in exchange for the same number of par value shares was not an original issue within the meaning of the applicable statute and regulations; and

(b) Whether, under the facts as stipulated, the District Court should have rendered judgment for appellant.

SPECIFICATION OF ERRORS TO BE RELIED ON

The District Court erred:

1. In finding that the amount of $6,304,845, transferred by appellant's predecessor from its Premium on Capital Stock Account to its Capital Stock Account at the time of the exchange of 3,772,763.0564 shares of its no-par value stock for the like number of outstanding shares of its $100 par value stock, was additional capital and that no

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shall be 10 cents on each $100 of actual value or fraction thereof of such certificates (or of the shares where no certificates were issued), or unless the actual value is less than $100 per share, in which case the tax shall be 2 cents on each $20, of actual value, or fraction thereof, of such certificates (or of the shares where no certificates were issued). The stamps representing the tax imposed by this subsection shall be attached to the stock-books or corresponding records of the organization and not to the certificates issued.

original issue tax was ever paid with respect to that amount (Its Finding No. 6, Tr. 79).

2. In failing to find that the said amount of $6,304,845 was not additional capital.

3. In finding and concluding that an original issue tax was incurred under the provisions of Section 1802 of the Internal Revenue Code, as amended, upon the issuance of said 3,772,763.0564 shares of no-par value stock in exchange for the like number of outstanding shares of $100 par value stock (Its Conclusion No. 1, Tr. 79).

4. In finding and concluding that when the $6,304,845 was transferred from the Premium on Capital Stock Account to the Capital Stock Account each of the new shares issued represented both old and new capital and was thus taxable as an original issue under the statute (Its Conclusion No. 2, Tr. 80).

5. In failing to find and conclude that the exchange of no-par value stock for par value stock was effected without the capital of the corporation being increased either by transfer of surplus to Capital Account or otherwise.

6. In failing to find and conclude that the issue of the 3,772,763.0564 shares of no-par value stock was not an original issue within the meaning of Sections 1800 and 1802 of the Internal Revenue Code and the applicable regulation.

7. In finding and concluding that appellant is not entitled to recover in this action and that appellee is entitled to recover judgment for his costs (Its Conclusion Nos. 3 and 4, Tr. 80).

8. In failing to find and conclude that appellant is entitled to recover in this action the sum of $46,687.95,

together with interest on said sum from February 26, 1943, as provided by law.

9. In rendering and entering judgment in this action in favor of appellee and against appellant and directing that appellee have and recover his costs of suit herein (Tr. 81-82).

10. In not rendering and entering judgment for appellant and against appellee in the sum of $46,687.95, together with interest on said sum from February 26, 1943, as provided by law.

SUMMARY OF ARGUMENT

The stamp taxes in question were unlawfully assessed, in that Sections 1800 and 1802(a) of the Internal Revenue Code, upon the basis of which the taxes were levied, require a corporation issuing stock to pay stamp taxes only upon an original issue thereof, and the subject issue was not an original issue within the meaning of the applicable Code provisions and their accompanying regulations. It was merely a reissue of shares to the holders of an original issue in exchange therefor.

ARGUMENT

I.

An Issue of Shares of No-Par Value Stock in Exchange for Shares with a Par Value Is Not Taxable as an Original Issue

It is definitely established as a matter of law that when a corporation issues shares of common stock in exchange for preferred stock, or vice versa, or shares of no-par value stock for shares with a par value, the shares issued in exchange are not taxable as an original issue, whether

or not the new stock carries different or greater rights and privileges than the old.[4]

In *Cleveland Provision Co. v. Weiss* (D.C., N.D. Ohio), 4 F.(2d) 408, four shares of no-par value stock were issued in exchange for each outstanding share having a $100 par value. It appeared that (p. 409):

> "In effecting this reorganization, no other change or readjustment took place with respect to the capital of the corporation. No additional contribution to the capital was made in connection therewith by its stockholders, and no part of the surplus, if any, was transferred to capital account and distributed with or as a part of the reissue. The exchange upon this basis was made. The net result was to leave the corporation assets, its capital and surplus, and its stockholders in precisely the same situation as before, except that each holder of a certificate of common stock of $100 par value had in lieu thereof at the end of the transaction four shares without nominal or par value."

The defendant (Government) contended the new certificates constituted original issues of capital stock and were, therefore, taxable. The Court answered this as follows (pp. 409-410):

> "The questions of law involved have been considered, and in my opinion settled, at least in principle, in the

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4. *Edwards v. Wabash Ry. Co.* (C.C.A. 2), 264 Fed. 610;
In re Grant-Lees Gear Co. (D.C., N.D. Ohio), 1 F.(2d) 393;
Cleveland Provision Co. v. Weiss (D.C., N.D. Ohio), 4 F.(2d) 408;
Cuba Railroad Co. v. United States, 60 Ct. Cl. 272;
West Virginia Pulp & Paper Co. v. Bowers (D.C., S.D. N.Y.), 293 Fed. 144, affd. 297 Fed. 225, cert. den. 265 U.S. 584;
The Bailey Co. v. Routzahn, D.C. Ohio E.D., decided Jan. 16, 1925, 1 U.S.T.C. par. 112.

following cases: Edwards v. Wabash Ry. Co. (2 C.C.A.), 264 F. 610; Trumbull Steel Co. v. Routzahn (D.C.), 292 F. 1009; American Laundry Mach. Co. v. Dean (D.C.), 292 F. 620; West Virginia Pulp & Paper Co. v. Bowers (D.C.), 293 F. 144; Bowers v. West Virginia Pulp & Paper Co. (2 C.C.A.), 297 F. 225, writ of certiorari denied, 265 U.S. 584, 44 S. Ct. 459, 68 L.Ed. 1191; Standard Mfg. Co. v. Remer (D.C.), 300 F. 252.

* * * * * * *

Upon the basis of the cases above cited, it is now settled that the statutory provisions in question require a corporation issuing stock to pay these stamp taxes only upon an original issue of stock. Sales, gifts, and transfers of such stock subsequent to the original issue are included, if at all, within other provisions of the act; and by original issue is meant the issue first in point of time, whereby the corporation puts out stock certificates evidencing ownership by its shareholders of its capital. Later exchanges of stock certificates between a corporation and the holders of its outstanding certificates are reissues, and not original issues; and this is true, even though the exchange consists in converting outstanding common into preferred, or outstanding preferred into common, with different rights and privileges in the capital assets, including changes in the right to vote, in the payment of dividends, and in distribution of assets on final liquidation. In the Edwards case this is precisely what was done, and resulted in a large increase both of new outstanding common and of first profit-sharing preferred.

The test is not whether the reissued stock is of a different kind from the original or outstanding issue. It is whether it is an original issue of certificates

> evidencing ownership in the corporate capital, or whether it is a reissue of shares to the holders of an original issue in substitution or exchange therefor."

It was contended that stock without par value was not within the decisions mentioned, that no-par stock is a wholly new kind of stock and should be regarded as the first or original issue by a corporation of that stock. The Court, however, rejected such contention.

In *Edwards v. Wabash Ry. Co.* (C.C.A. 2), 264 Fed. 610, the Wabash Railway had outstanding two classes of preferred stock, A and B, and also common stock. It called in its preferred stock B and converted it, part into preferred A and part into common, and issued new certificates to the holders thereof conferring new and different rights and privileges in the corporate property and management. The Commissioner ruled that the certificates issued in exchange were original issue.

The Railway Company maintained that conversion of preferred stock B into prescribed amounts of preferred A and common stock did not involve an increase of the capital stock of the company but was merely a reclassification of certain existing stock pursuant to an arrangement at the time of organization of the company and that the transaction did not involve an issue of "original" stock. The Court, in upholding this contention, stated (pp. 615-616):

> "A stock certificate is a document which is the evidence of the number of shares of stock which the holder of it owns. And the tax is laid, not on each stock certificate that is issued, but on each original issue of certificates. The language is used to indicate

the first issuance of the stock, and this is emphasized by the use of the words, in the same connection, 'whether on organization or reorganization.' When a corporation issues for the first time a certificate of the stock, that certificate is an original issue. The tax is placed on the *original* issue. The word 'original' is defined by Webster as 'pertaining to the origin or beginning; preceding all; first in order.' Plainly, then, it was not intended to tax the plaintiff on each issue of certificates, but only on each original issue of certificates which preceded all other issues which might subsequently be made, when the original certificates were surrendered and new ones issued in their place, either to the original owner or to those to whom the original owners had transferred them.

The taxation of such subsequent issues involving a change of title is provided for in section 4 of schedule A, title VIII, which imposed a tax on transfers, and imposes it, not on the company, but on the holder, and fixes the rate of the tax at 2 cents on each share having a face value of $100, instead of 5 cents, which is the rate imposed on the company in connection with the original issue.

* * * * * * *

In the case at bar, when the plaintiff paid at the time of its organization the tax of 5 cents for each $100 of face value of its total capital stock, including the A stock, and B stock, and the common stock, such payment was made once for all, and constituted the payment of the tax on each original issue of the certificates of stock whenever and to whomsoever delivered. Whenever thereafter the plaintiff delivered the first certificates of the B stock, it was not under obligation to pay again the tax on the B certificates. That had been already done; and when, subsequently,

the plaintiff exchanged the certificates of the B stock for certificates of the A stock and of the common stock, it was not bound to pay again the tax on the certificates. That tax, too, had been already paid. The exchange of stock was an exchange of original certificates of one kind of stock for original certificates of two other kinds of stock, the tax on all of which had been previously paid."

In each of the cases involving an exchange of shares of stock, wherein the original issue tax was held applicable to the certificates issued in exchange,[5] there was present one or more of the following elements:

(a) a contribution of additional capital by the stockholders;

(b) a transfer of *earned* surplus to capital account; or

(c) a revaluation of assets due to an increment in value, and a transfer of such increment to capital account (the increment itself representing additional earnings—*Com'r v. Wakefield,* 139 F.(2d) 280; *Binzel v. Com'r* (C.C.A. 2), 75 F.(2d) 989, cert. den. 296 U.S. 579).

These cases, wherein the original issue tax was held applicable, however, are readily distinguishable from the present case. Here there was no change in the Old Company's surplus account, no change in the number of its

5. *American Gas & Electric Co. v. United States* (D.C., S.D. N.Y.), 69 F. Supp. 614;
Ohio State Life Insurance Co. v. Busey (D.C., S.D. Ohio), 56 F. Supp. 410;
Rio Grande Oil Company v. Welch (C.C.A. 9), 101 F.(2d) 454.

shares outstanding, and no change in its "Total Stock" account (Tr. 64, Stip. 15). There was no new contribution to capital by the stockholders (Tr. 61, Stip. 12) and no part of the corporate surplus was assigned to capital accounts (Tr. 52, Stip. 6).

The book value of the stock remained unchanged. Prior to the change from par to no-par shares, the total amount in the said capital stock accounts was $383,581,150.64; after the change to no-par shares, the amount in said accounts was still $383,581,150.64 (Tr. 61-64, Stips. 13, 15). The change from par to no-par was nothing more than a change in the form of the certificates. There was no revaluation of the properties of the Old Company with appreciation thereof and increase of values transferred to capital account. There was no change in the assets of the company and no change in the interests of the stockholders. There was an exact exchange. No new shares were created. The rights of the stockholders were neither increased nor lessened by the change from par value stock to no-par value stock.

The only change was the merger of the amount of $6,304,845 carried in the subsidiary capital stock subaccount with the amount of $377,276,305.64 carried in the principal capital stock subaccount. Where there had been before the exchange, a breakdown of the "Total Stock" of $383,581,150.64 into two subaccounts, after the exchange there was no longer any breakdown but instead a merger of the amount in the subsidiary capital stock account with the amount in the principal capital stock account, without, however, any change in the "Total Stock" or book value of the stock (Tr. 61-64, Stip. 13, 15).

What was done in this case was merely an exchange of new certificates of no-par value stock for original certificates of par value stock. All the certificates covering the 210,157 shares of par value stock in respect of which the $6,304,845 premium on capital stock was realized, were certificates upon which the original issue tax was paid, with the exception of the certificates applying to 5,093 shares which were issued at a time when no original-tax law was in effect and on which a premium of but $152,970 was realized (Tr. 62-63, Stip. 14). On all remaining parts of the capital stock which were issued during periods when federal stamp taxes were in effect, such stamp taxes were duly paid (Tr. 50, Stip. 4).

No tax was paid in respect to or computed upon the amount of $6,304,845 premium which was realized at the time the 210,157 shares of par value stock were originally issued (Tr. 65, Stip. 15), *as no tax was due in respect to or computed upon that amount,* all applicable taxes in respect of the certificates to which that amount appertained having been duly paid (Tr. 62-64, Stip. 14).

As stated in *Edwards v. Wabash Ry. Co.* (C.C.A. 2), 264 Fed. 610, 614-5, the original issue tax is laid, not on each certificate or on each issue of certificates, but only on each *original* issue of certificates. It is measured by the par value of all shares in each certificate in cases of par value stock, and by the actual value of all shares in each certificate in cases of no-par value stock. It is immaterial in the case of par value stock what consideration therefor is received by the issuing corporation, whether greater or less than or equal to the par value, as *the tax is not a tax on the capital,* i.e., the assets received by the corporation

upon the original issuance of the certificates, but is a tax on the certificate.[6]

When Congress decreed that the tax should be computed upon the par value in the case of par value stock, it in effect made the premium or excess over par value tax-free by excluding it from the measure of the tax. As Congress has made such excess tax-free, it must have intended that it remain tax-free in the absence of plain language to the contrary, and it cannot fairly be deemed to have intended that the tax should apply to new certificates issued in exchange for certificates of an original issue of par value stock upon which a premium was realized, when all that is done, in addition to the exchange of certificates, is a mere shifting of such excess from one "Total Stock" subaccount to another "Total Stock" subaccount, and where, in the absence of such shifting, the original issue tax unquestionably would not be applicable. When the tax was paid on the original issue of such of the certificates of par value stock as were issued when federal stamp taxes were in effect, it was, as stated in *Edwards v. Wabash Ry. Co.*, 264 Fed. 610, 616, paid once for all; and when thereafter the new no-par value certificates were issued in exchange for the original par value certificates, the company was not bound to pay again the tax on the certificates. The remaining certificates of original issue in respect of which no prior tax was paid were issued during the period when no federal stamp tax levy was imposed and therefore were tax-free. Upon their reissue, no tax became due.

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6. *American Gas & Electric Co. v. United States* (D.C., S.D. N.Y.), 69 F. Supp. 614.

II.

There Was No Increase in the Capital of the Old Company, and the Subject Issue Is Specifically Exempt by the Applicable Regulation.

There was no increase in the capital of the Old Company incident to the exchange of the no-par value stock for the par value stock. This, it is submitted, is clear from a consideration, in the light of the record in this case, of the pertinent provisions of the Kentucky statutes and of the applicable regulation.

Chapter 32 of the Kentucky Statutes (Baldwin's 1936 Revision) contains the corporation laws of Kentucky in effect during the period here involved. The provisions thereof dealing with amendments of the articles of railroad corporations are set forth in Article V, Section 764, which reads:

> Sec. 764. *Amendment of articles; execution and filing of*—The articles of incorporation may be amended and changed in the manner provided in article one of this chapter; and a copy of any amendment or alteration, attested by the president and secretary of the corporation, shall be filed in the office of the railroad commissioners and the secretary of state within thirty days after its adoption by the corporation; and when so filed, and a certificate of that fact is delivered to the president or secretary, the corporation shall have the right to make such alterations and changes in its business as are authorized by the amended articles.

"Article one," referred to in Section 764, takes in the sections dealing with corporations generally, including Sections 559 and 564-2, which are set forth in full in the

Appendix. Sections 559 and 564-2, so far as here material, provide:

> Sec. 559. *Amendment of articles of incorporation.* —Any corporation may, by the consent in writing of the owners of at least two-thirds of its capital stock, change or amend any of the articles of its incorporation, and such alteration or amendment shall be signed and acknowledged by the directors, or a majority of them, and filed and recorded as articles of incorporation are required to be.
>
> Sec. 564-2. *Stock without par value.*—Any corporation organized under this law may, if so provided in its certificate of incorporation or in an amendment thereof, issue shares of stock * * * without any nominal par value * * * Such stock may be issued by the corporation from time to time for such consideration as may be fixed from time to time by the board of directors thereof, pursuant to authority conferred in the certificate of incorporation, * * *

The Old Company was a Kentucky corporation, and it was pursuant to the foregoing provisions that its Articles of Incorporation were amended and the 3,772,763.0564 shares of no-par value stock issued in exchange for the like number of outstanding shares of par value stock. These general provisions, however, do not govern an augmentation of the capital of the corporation. Other provisions of the Kentucky Statutes, hereinafter referred to, set forth in detail the manner in which increases or decreases in the capital of a corporation are to be accomplished; and, in accordance with the established rules of statutory construction that specific provisions prevail over those of a general nature to the extent of any inconsistency, such other provisions are controlling and govern

the procedure to be followed in effecting a valid increase in capital.[7]

Following the amendment of the Articles of the Old Company, it is true, there was a transfer on its books pursuant to the requirements of the Interstate Commerce Commission of the sum of $6,304,845 from one subaccount of the Total Stock Account to another. But, in determining whether there has been an increase or decrease in the capital of a corporation, book entries alone are not decisive. As stated by this Court in *Rio Grande Oil Co. v. Welch* (C.C.A. 9), 101 F.(2d) 454, 456:

> "An increase or decrease in the stated capital of a corporation effects a fundamental change in the corporate structure * * *; and formal action on the part of the corporation is necessary to bring such changes about. In modern practice they are usually governed by statute and, where so governed, changes in stated capital may be effected only through pursuit of the statutory method."

Section 771, Article V, and Sections 553 and 564-1, Article I, Chapter 32, Kentucky Statutes, which sections are set forth in full in the Appendix, provide how the capital of a railroad corporation may be increased. Those sections, so far as here material, provide:

> Sec. 771. *Borrowing and mortgaging to complete or operate road; preferred and common stock; rights of each class.* Corporations [railroads] organized under this law * * * may in the manner provided in article I of this chapter increase or decrease *in its*

7. *Sutherland's Statutory Construction,* 3d Ed., Sec. 5204; 59 *C.J.* 1000-1001; *Oppenheimer v. Commonwealth,* 305 Ky. 146, 202 S.W.(2d) 373; *Ingram v. Commonwealth,* 176 Ky. 706, 197 S.W. 411, 413.

capital stock; and the increased stock may be common or preferred as shall be designated in the call for the meeting of stockholders.

Sec. 553. *Capital stock; manner of increasing or reducing.*—Any corporation may increase or reduce its capital stock at any time by a vote of, or by the written consent of, stockholders representing two-thirds of its capital stock, and after notice of the proposed increase or decrease has been mailed to the address of each stockholder at least twenty days before the meeting is held for that purpose; and a statement of the increase or reduction shall be signed and acknowledged by the president and a majority of the directors, and filed and recorded in the same manner as articles of incorporation; * * *

Sec. 564-1. *Corporation may divide its shares into classes; common and preferred stock; increase of stock; rights of holders in dissolution.*— * * * Any [corporation organized under this law], all of whose outstanding stock is common stock, may by a resolution adopted by the vote of the holders of not less than two-thirds in amount of its outstanding capital stock, cast in person or by proxy, at a special meeting of stockholders called for the purpose and of which notice shall have been given as provided in the by-laws of the company, at least twenty days before the date of the meeting, or at the annual meeting of the stockholders of the company, or by the written consent of the holders of not less than two-thirds in amount of its capital stock, distribute or convert its outstanding capital stock into preferred and common stock in such proportion as shall be fixed by such resolution or written consent * * * And by a resolution adopted by the like vote or by such written consent, the capital stock of any corporation may be increased and the increased stock may be common or

preferred stock, or partly one and partly the other, as may be fixed by such resolution or written consent * * *

The words "capital stock," as used in the foregoing provisions, designate the amount of capital contributed by the stockholders for the use of the corporation, that is, the amount paid in by the stockholders of the corporation, in money, property or services, with which to conduct its business.[8] They mean a genuine addition to the property, permanently dedicated to the business enterprise for the prosecution of which the corporation was organized.[9]

It will be noted from the provisions of Section 553 that if a corporation desires to increase its capital it can do so only by an instrument in writing, which must specifically state on its face the amount of the proposed increase and must be filed and recorded in the same manner as Articles of Incorporation. While Section 564-1 does not itself specifically provide for the filing of an amendment setting forth the amount of a proposed increase in capital, that section must be construed with Section 764 above referred to, which does specifically require such filing. In view of this, it is clear that, if it had been desired to increase the capital of a Kentucky railroad corporation under the provisions of Section 564-1, it could be done only by the filing of an amendment containing a statement of such increase.

There is nothing in the record of this case to indicate any attempt to conform to those provisions of the Ken-

8. *Haggard v. Lexington Utilities Co.,* 260 Ky. 261, 84 S.W. (2d) 84, 87.

9. *Hood River Co. v. Commonwealth,* 131 N.E. 201.

tucky law and thereby effect an increase in the capital of the Old Company, nor is there any suggestion in the record that the Old Company entertained such a purpose. It will be noted from the stipulation that both the resolution adopted by the Board of Directors (Tr. 55-58, Stip. 9) and that adopted by the stockholders (Tr. 59-61, Stip. 11) failed to mention or disclose any intent to increase the capital of the Old Company. The Certificate of Amendment (Tr. 52-53, Stip. 7) that was filed in accordance with the requirements of the Kentucky Statute merely provided:

> "That the authorized capital stock of said Company consisting of 5,944,518 common shares of the par value of $594,451,800, of which 3,772,763.0564 shares are issued and outstanding, and 2,171,754.9436 shares are unissued, be changed into the same number of common shares without nominal par value;
>
> That 3,772,763.0564 shares of said shares without nominal par value be substituted, share for share, for the said presently issued and outstanding shares of the par value of one hundred dollars ($100) each;
>
> That the unissued 2,171,754.9436 shares of said authorized shares without nominal par value may be issued by the Company from time to time in such amounts, upon such terms, for such proper corporate purposes, and for such consideration or considerations as may be fixed from time to time by the Board of Directors."

It is clear that the amendment provided for no more than a change in the character of the stock, with authority to issue the shares in excess of those to be exchanged for such consideration as the Board of Directors may fix from time to time.

There is no presumption that the process involved an increase in capital,[10] nor was there any effort to issue in disguise a stock dividend. No new shares were created. When the exchange of certificates of the old for the new shares of stock had been effected, the stockholders were unchanged. The relative holdings of the then issued and outstanding stock and the rights and burdens of membership in the corporation were the same, while the corporate assets and liabilities, including total stock liability, had been neither increased nor diminished. There was no change in the Surplus Account, no change in the number of shares outstanding, and no change in the Total Stock Account (Tr. 64, Stip. 15). There was no new contribution to capital by the stockholders (Tr. 61, Stip. 12), and no part of the corporate surplus was assigned to Capital Account (Tr. 52, Stip. 6) and distributed in connection therewith as a stock dividend.

The premium on capital stock, under the Kentucky corporation laws, could equally as well have been distributed as dividends after the exchange as before. If there was no statutory impediment to such distribution before the exchange, there was none thereafter. The only prohibition against the declaration and payment of dividends under the Kentucky corporation law is set forth in Section 548, Chapter 32, Kentucky Statutes (now Section 271.220 KRS). That section reads:

> Sec. 548. *Directors; when liable for debts of corporation.*—If the directors of any incorporated company shall declare and pay any dividend when the corporation is insolvent, or any dividend the payment of which would render it insolvent, or which would

10. *Rio Grande Oil Co. v. Welch* (C.C.A. 9), 101 F.(2d) 454.

> diminish the amount of its capital stock, they shall be jointly and severally individually liable for all debts of the corporation then existing, and for all that shall be thereafter incurred while they, or a majority of them, continue in office. (1893, c. 171, p. 612, Sec. 11.)

It will be noted that the prohibition, where insolvency is not involved, is directed against the payment of any dividend only where the effect of such payment would be to diminish the amount of the capital stock. The action taken by the stockholders and directors of the Old Company was ineffectual under Kentucky law to increase the capital stock of the Old Company, and therefore the amount of its capital stock was the same after the exchange as before; consequently, the statutory right of the directors to declare and pay dividends was unaffected by the transfer to the Capital Stock Subaccount of the amount theretofore carried in the Premium on Capital Stock Subaccount.

In view of the foregoing, it is respectfully submitted that there was no increase in the capital of the Old Company incident to the exchange of no-par value stock for the outstanding shares of par value stock.

The applicable regulation itself expressly recognized that the transaction was tax-exempt. Reg. 71 (1932 Ed.), Art. 29(i), which was in effect as of April 23, 1940, the date of the exchange, cites, as an example of an issue not subject to the tax:

"(i) The issue by a corporation of certificates of stock in exchange for outstanding certificates of its own stock where such exchange is effected without the capital of the corporation being increased, either by transfer of surplus to capital account or otherwise."

The word "capital" may have different meanings when used in different connections. It must be construed in the regulation by reference to the context and other rules of construction. It apparently is the position of the Commissioner of Internal Revenue that in this instance it means "capital stock" or "legal capital." Even if this were so, the provision nevertheless would be controlling in this instance, for, as has been clearly established, the action taken by the Old Company, its stockholders and its directors, even had it been so intended, would have been ineffective to create a valid increase in the capital of the Old Company.

It is respectfully submitted, however, that, as used here, the word "capital" means the amount invested by the stockholders in the corporation, whether representing "legal capital"—that is, property sufficient to balance the capital stock liability—or paid-in surplus or capital surplus in any form.

It will be observed that the word "capital" is used in the regulation and not "capital stock" or "legal capital," from which it is clear that the word "capital" as used relates to the capital account. That this is the meaning properly to be ascribed to the word is confirmed by the use in the regulation of the phrase "either by transfer of surplus to *capital account* or otherwise." These latter words are not to be ignored. They do not constitute a

limitation upon the word "capital" but plainly broaden it. They clearly evidence the fact that the "capital" referred to in the regulation is the capital that, in accordance with sound and accepted accounting procedure, is included in "capital account." If by transfer of surplus to "capital account" additional "capital" is created, it must necessarily follow that the terms "capital account" and "capital," as used in the regulation, are synonymous.

Fundamentally, surplus is divided into capital surplus and earned surplus. Accretions to capital arising from premiums on capital stock are known as "capital surplus."[11] The amount received from premium on capital stock is clearly a capital receipt.[12] As used in the regulation, the unqualified word "surplus" undoubtedly means that part of the surplus which was derived from profits which at the close of earlier accounting periods were carried into surplus as undistributed earnings of the business. It has no application to capital, or paid-in, surplus arising from premium on capital stock. The capital account includes the paid-in surplus and there can be no "transfer" to capital account of something which is already there.

These views find ample support in the decisions of the Board of Tax Appeals (now Tax Court) and in the regulations of the Treasury Department itself.

In *Jarvis,* 43 BTA 439, aff'd 123 F.(2d) 742, where the corporation involved was organized with authorized capi-

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11. *Montgomery, Auditing Theory and Practice,* 4th Ed., p. 329; *Hatfield, Sanders and Burton, Accounting Principles and Practices* (1940 Ed.), pp. 250, 264; *Paton's Advanced Accounting* (1941 Ed.), pp. 522-523.

12. *Montgomery, Auditing Theory and Practice,* 4th Ed., p. 634.

tal stock of $1,000,000 represented by 10,000 shares and began business with a paid-in surplus of $911,499.66, the Board stated (p. 444):

> "The Acheson corporation has but one 'capital account' and that account consists of the original amount received for its capital stock, comprising both the par value and the paid-in surplus, *August Horrmann,* 34 BTA 1178, 1186-7; *Arthur C. Stifel,* 29 BTA 1145, 1150."

Moreover, under each of the revenue acts from 1918 to 1932, inclusive, the Treasury regulation[13] in respect to the acquisition or disposition by a corporation of its own stock was as follows:

> "The proceeds from the original sale by a corporation of its shares of capital stock, whether such proceeds are in excess of or less than par value of the stock issue, constitute the capital of the company. If the stock is sold at a premium, the premium is not income. Likewise, if the stock is sold at a discount, the amount of the discount is not a deductible loss from gross income."

In 1934 this regulation was amended so as to make taxable those transactions where a corporation dealt in its own shares as it might have done in the shares of another corporation, but such amendment did not effect any change in the foregoing principle.

It is of no consequence that the ascertainment of the fact that the capital account comprises both the par value and the paid-in surplus, or that the premium on capital

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13. Art. 542, Reg. 45; Art. 543, Regs. 62, 65, 69; Art. 66, Regs. 74, 77.

stock constitutes a part of the capital of the company, may have been for different uses under the decisions and regulation mentioned; the fact is the same irrespective of its use for those purposes or for the purpose of determining whether the capital of a corporation has been increased within the meaning of the subject regulation.

These views also find full support in the subsequent corresponding regulation, Section 113.25(f), Reg. 71 (1941 Ed.), which amended the applicable regulation in effect as of April 23, 1940, the date the no-par value stock was exchanged for the par value stock. The regulation as amended reads as follows:

> "The following issues are not subject to tax:
>
> * * * * * * *
>
> (f) The issue of stock in a recapitalization or reorganization where there is no dedication of additional capital, either by transfer of earned surplus or otherwise."

This amended regulation in substance is the same as the prior regulation which it superseded, and it is respectfully submitted that were it controlling in the present instance it would support the position of the appellant as hereinabove set forth.

As heretofore shown, "capital account" comprises both "legal capital" and "paid-in surplus." It does not include "earned surplus," which is a component of the "income account." The amended regulation speaks of *earned* surplus. It is significant that in amending the language and eliminating the reference to "capital account" incorporated in the prior regulation, the Treasury Department deemed it necessary to interpolate the word

"earned" before the word "surplus," where only the latter word had previously appeared. The word "earned" undoubtedly was used in the amended regulation in contrast to "paid-in," with the intention of emphasizing the fact that the "additional capital" referred to is the capital which, in accordance with sound and established accounting practices, is included in capital account, and also to emphasize the fact that there can be no "transfer" of "paid-in surplus" to "capital" inasmuch as "paid-in surplus" is a capital receipt which, when paid in by the stockholders, immediately becomes a part of "capital." The use of the word "earned" indicates a conscious intent on the part of the Treasury Department to phrase the revised language in such a manner that the amended regulations should not be construed as constituting a change in the substance of the prior regulation. If this were not so, no purpose would be served by the presence of the word "earned."

The words "or otherwise," as used in the regulation, do not negative this conclusion. Those words contemplate a "dedication of additional capital" to capital account by some means other than a "transfer of earned surplus." They contemplate the addition to capital account of something new which has been created or contributed, and do not contemplate something which has previously become a component of the capital account as an incident to an earlier issuance of certificates. They do not comprehend "paid-in surplus" realized upon the issuance of prior tax-paid or tax-free certificates, which already exists in the capital account at the time of the recapitalization or reorganization. Where, as in this instance, no additional

capital has been created or realized, there can be no "dedication of additional capital."

There is nothing in the fact that in this instance the capital surplus in the Premium on Capital Stock Subaccount was transferred to the Capital Stock Subaccount to justify the inference that there was or was intended to be any dedication of additional capital within the meaning of the regulation. The Bureau of Internal Revenue itself has ruled that the transfer from capital surplus to capital stock does not give rise to the original-issue tax.

In Bureau letter dated May 10, 1940, 403 CCH, par. 6281, it was held that no original issue stamp taxes were incurred as a consequence of the recapitalization of a corporation resulting in an increase in the capital stock account, where such increase was effected by transferring from the capital surplus account the exact amount necessary to consummate the increase in the capital stock account and where no new shares were issued to persons other than the old stockholders. That case involved an exchange of 4% $100-par preferred stock for outstanding 8% preferred and an exchange of new $10-par common for outstanding no-par common. The Commissioner, in his ruling to the Collector in that case, stated:

> "Before the exchange is made the total capital stock of the corporation will be in the amount of $104,962.00, consisting of 1,000 shares of $100.00 par value 8 per cent preferred stock and 4,962 shares of no par value common stock, having a stated value of $1.00 per share. Subsequent to the exchange the total capital stock account will be in the amount of $199,620.00, representing an increase of $50,000.00 in the preferred stock and $44,658.00 in the common

stock. The increase in the capital stock account has been effected by transferring an amount of $94,658.00 from the company's capital surplus account, to which account there was credited in July, 1930, the amount by which the capital stock was reduced, namely, $499,158.00.

On the basis of the analyses of the capital stock accounts as set forth above, this office concludes that no stamp taxes have been incurred as a result of the recapitalization of August 1, 1939. This is so for the reason that the increase in the capital stock account was effected by transferring from the capital surplus account the exact amount necessary to consummate the increase in the capital stock accounts. It is immaterial that part of the increase is reflected in the preferred capital stock account and part in the common capital stock account. The total amount by which the capital stock accounts were increased by virtue of the recapitalization of August 1, 1939, was not greater than the amount of capital transferred to capital surplus in 1930, which amount has previously been subject to the issue tax. No stamp tax is therefore incurred on the issuance of the new shares."

The position which appellant maintains in this case is consistent with the foregoing ruling. There the capital surplus transferred to capital stock was realized upon the issuance of tax-paid certificates. Here the capital surplus of $6,304,845 transferred to the Capital Stock Subaccount likewise was realized upon the issuance of tax-paid certificates, with the exception of the small amount of $152,790 which was realized upon the issuance of tax-free certificates. The ruling, it is true, states that the amount of capital there transferred to Capital Stock "has previously

been subject to the issue tax." However, it is not the "amount" which is subject to the issue tax. The tax is not on the "amount" but is on the certificate in respect of which the amount is realized.[14] Here the certificates in respect of which the $6,304,845 was realized were either tax-paid or tax-free. They had been either previously subject to the issue tax or free of any issue tax; and upon their reissue, no tax became due. The principle of the foregoing ruling, therefore, is equally applicable here.

III.

The Commissioner of Internal Revenue May Not Resort to the Rules of the Interstate Commerce Commission Adopted for Other Purposes, for the Purpose of Levying Taxes Under the Internal Revenue Code.

In connection with the exchange of stock certificates here involved, there was, as previously stated, no additional contribution by the stockholders to the capital of the corporation (Tr. 61, Stip. 12) nor any transfer of any part of the surplus to capital account (Tr. 52, Stip. 6). The corporate assets, its capital and surplus and liabilities (Tr. 64, Stip. 15), and its stockholders, were in precisely the same situation after the exchange as before, except that each holder of a certificate of common stock of $100 par value had in lieu thereof at the end of the transaction one share without nominal or par value. The only change was the merger of the $6,304,845 theretofore carried in the Premium on Capital Stock Subaccount with the $377,276,305.64 theretofore carried in the Capital Stock Subaccount. This change was effected, however, without

14. *American Gas & Electric Co. v. United States* (D.C. S.D. N.Y.), 69 F. Supp. 614.

any change in the Total Stock liability of $383,581,150.64 (Tr. 64-65, Stip. 15). Under the requirements of the Interstate Commerce Commission, of which this Court takes judicial notice,[15] it was mandatory upon the Old Company to make this change. In the absence of the directive of the Interstate Commerce Commission that such procedure be followed, no necessity would have existed for the merger of the two amounts. The capital account could have been maintained after the exchange as a single accounting element broken down into its component parts in the same manner as it was before the exchange.

Had the merger of the two amounts not occurred, the Commissioner of Internal Revenue undoubtedly would not have questioned the applicability in this instance of the principle of *Edwards v. Wabash Ry. Co.*, 264 Fed. 610, and *Cleveland Provision Co. v. Weiss,* 4 F.(2d) 408, and no original issue tax would have been exacted. It is only by reason of the merger of the two amounts that the Commissioner contends that the original issue tax is applicable here.

Not only is it manifestly inequitable that a taxpayer should be penalized by one government agency merely for doing that which another co-ordinate government agency requires it to do, but also such procedure is wholly without warrant in the law. The Supreme Court of the United States in *Old Colony Rd. Co. v. Commissioner,* 284 U.S. 552,562, expressly held that the Commissioner of Internal Revenue may not resort to the rules of the Interstate Commerce Commission, made for other purposes, for the

15. *Lilly v. Grand Trunk R. Co.*, 317 U.S. 481, 488; *Uniform System of Accounts for Steam Railroads* prescribed by Interstate Commerce Commission.

determination of tax liability under the revenue acts—which is precisely what the Commissioner of Internal Revenue did in this instance.

The Accounting Rules of the Commission were adopted for the purpose of reflecting conveniently and uniformly the financial position of those companies whose accounting is subject to its authority. By these rules the Commission did not purport to change the legal aspects of corporate action and, indeed, it has no power to do so since the internal affairs of a company are subject to the laws of the state in which it is incorporated.[16] We have pointed out *supra,* pages 22-26, that no action pursuant to Kentucky law was taken by the Old Company augmenting or otherwise changing its capital. No change in the legal capital of the Old Company would or could have occurred merely by conformity to a change required by the Commission as to the description of the $6,304,845 of premiums previously received in the sale of capital stock.

The common-sense explanation of the whole matter is that the Commission, in formulating its Accounting Rules, felt that "premium on capital stock" was appropriate, when par value stock is involved, to describe the excess received over par, but was not appropriate to describe any part of the price received on the sale of no-par value stock. So when par value stock was exchanged for no-par value stock, it required a change in the description of the premium by the device of requiring the amount of the premium to be transferred from Subaccount 753 "Premium on Capital Stock," to Subaccount 751, "Capital

16. *Callaway, as Trustee of the property of Central of Georgia Ry. Co. v. Benton,* Sup.Ct. of U.S., No. 21, Oct. Term 1948, dec. Feb. 7, 1949.

Stock." There is nothing to indicate that the Commission was seeking to require any substantive change in the capital or corporate structure of the Old Company. The Accounting Classification and Regulations of the Commission are promulgated by it pursuant to the authority over the accounting of carriers conferred by paragraphs (3) and (5), Section 20, of the Interstate Commerce Act (49 USCA, 1948 Supp. p. 30), and it should not be inferred that the Commission, under the guise of issuing accounting rules, was going further and requiring a change in the legal capital of carriers.

The Commission's accounting regulations went to nomenclature, the appropriate description of sums which had been received as premiums on the sale of stock. They did not change the substantive capital of the Old Company so as to enhance or decrease the ability of that company to pay dividends. No such matter was submitted to the stockholders of the Old Company as would be required by Kentucky law. The Commissioner of Internal Revenue has seized upon accounting rules relating to proper terminology and nomenclature for the entirely different purpose of asserting that there was an increase in capital and consequently an event giving rise to the tax liability asserted. This is precisely what the Supreme Court said the Commissioner could not do in *Old Colony Rd. Co. v. Commissioner, supra.*

It may be that equitable considerations do not have much play in determining liability for excise taxes. If there had been an increase in capital as a result of this transaction in the amount of $6,304,845, as contended by appellee, the Old Company became vulnerable to the im-

position of a tax as on an original issue of 3,772,763.0564 no-par value shares, replacing the same number of shares with an aggregate value of $377,276,305.64. This does not seem equitable, but the answer of appellee and of the Court below is that there was such an intermingling of the large amount of old capital and the comparatively small amount of alleged new capital that a tax on the issuance of all the shares cannot be avoided. However, the taxpayer may reasonably ask that the premise upon which this seemingly untoward result is predicated be clearly established. There is still some vitality to the often repeated rule that provisions of taxing statutes are not to be extended by implication beyond the import of the language used, or so as to enlarge their operation or to embrace matters not specifically pointed out.[17] Here the Commissioner may not seize upon a change of nomenclature arising from the shifting of a sum from one capital account to another as required by the Commission, to assert that there was a dedication of additional capital, unintended by stockholders or directors, giving rise to the asserted tax liability.

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17. *Edwards v. Wabash Ry. Co.* (C.C.A. 2), 264 Fed. 610, 616-617;
Gould v. Gould, 245 U.S. 151;
United States v. Field, 255 U.S. 257, 18 A.L.R. 1461;
United States v. Woodward, 256 U.S. 632;
Smietanka v. First Trust and Savings Bank, 257 U.S. 602;
McFeely v. Commissioner, 296 U.S. 102, 111.

CONCLUSION

In view of the foregoing, it is respectfully submitted that the 3,772,763.0564 shares of no-par value stock issued in exchange for the same number of par value shares was not an original issue within the meaning of the applicable statute and regulations, and the judgment should be reversed, with instructions to the Court below to enter judgment in favor of appellant for the recovery from appellee of the sum of $46,687.95 together with interest on said sum from February 26, 1943, as provided by law, and for such other and further relief as to the Court may seem just and proper.

Respectfully submitted,

George L. Buland
Frank J. Gallagher
Attorneys for Appellant

Dated at San Francisco, February 16, 1949.

(Appendix follows)

APPENDIX

KENTUCKY STATUTES

Chapter 32

Corporations; Private

ARTICLE I.

General Provisions Concerning

§548. *Directors; when liable for debts of corporation.* —If the directors of any incorporated company shall declare and pay any dividend when the corporation is insolvent, or any dividend the payment of which would render it insolvent, or which would diminish the amount of its capital stock, they shall be jointly and severally individually liable for all debts of the corporation then existing, and for all that shall be thereafter incurred while they, or a majority of them, continue in office. (1893, c. 171, p. 612, §11.)

§553. *Capital Stock; manner of increasing or reducing.* —Any corporation may increase or reduce its capital stock at any time by a vote of, or by the written consent of, stockholders representing two-thirds of its capital stock, and after notice of the proposed increase or decrease has been mailed to the address of each stockholder at least twenty days before the meeting is held for that purpose; and a statement of the increase or reduction shall be signed and acknowledged by the president and a majority of the directors, and filed and recorded in the same manner as articles of incorporation; but no increase of the capital stock of a banking or trust company shall be valid until the amount thereof has been bona fide sub-

scribed, and one-half thereof actually paid in, and the remainder shall be paid in within one year. (1893, c. 171, p. 612, §16.)

§559. *Amendment of articles of incorporation.*—Any corporation may, by the consent in writing of the owners of at least two-thirds of its capital stock, change or amend any of the articles of its incorporation and such alteration or amendment shall be signed and acknowledged by the directors, or a majority of them, and filed and recorded as articles of incorporation are required to be. (1893, c. 171, p. 612, §22.)

§564-1. *Corporation may divide its shares into classes; common and preferred stock; increase of stock; rights of holders in dissolution.*—Any corporation organized under this law may divide its shares into classes, such as preferred, common and deferred shares, or as may be otherwise designated, and it may give to each of the several classes such priority of right in the payment of the dividends, and in the redemption of the shares, as may be prescribed in the rules and regulations adopted by the shareholders; and may provide that the holders of its bonds shall be entitled, upon terms prescribed by it, to convert the same into the stock of the corporation, whether common or preferred, and that holders of its preferred stock shall be entitled, upon terms prescribed by it, to convert the same into the bonds or other obligations of the corporation. No preferred stock shall be issued except for cash or its equivalent, nor for less than the par value of the shares, which shall be stated in the certificates representing the preferred and common stock respectively. Any such corporation, all of whose outstanding stock is

common stock may, by a resolution adopted by the vote of the holders of not less than two-thirds in amount of its outstanding capital stock, cast in person or by proxy, at a special meeting of stockholders called for the purpose and of which notice shall have been given as provided in the by-laws of the company, at least twenty days before the date of the meeting, or at the annual meeting of the stockholders of the company, or by the written consent of the holders of not less than two-thirds in amount of its capital stock, distribute or convert its outstanding capital stock into preferred and common stock in such proportion as shall be fixed by such resolution or written consent: Provided, that all holders of stock of the company at the time of such distribution shall be entitled to the same pro rata proportions of such preferred and common stock. And by a resolution adopted by the like vote or by such written consent, the capital stock of any corporation may be increased and the increased stock may be common or preferred stock, or partly one and partly the other, as may be fixed by such resolution or written consent. Any such preferred stock hereinbefore referred to shall be entitled to receive quarterly, semi-annual or annual dividends thereon at such rate as may be prescribed by the resolution or written consent under which the same was issued, and such dividends shall be payable as provided in the said resolution or written consent, before any dividends shall be declared on the common stock; and on the dissolution of the company, voluntary or otherwise, the holders of preferred stock shall be entitled to have their shares redeemed at par before any distribution of any part of the assets of the company shall be made to the

holders of the common stock. (April 5, 1893, c. 171, p. 612, §27; March 25, 1904, c. 105, p. 257; March 3, 1910, c. 79, p. 231, as amd. March 1, 1926, c. 73, p. 198, subs. 1.)

§564-2. *Stock without par value.*—Any corporation organized under this law may, if so provided in its certificate of incorporation or in an amendment thereof, issue shares of stock (other than stock preferred as to dividends or preferred as to its distributive share of the assets of the corporation or subject to redemption at a fixed price) without any nominal par value. Every share of such stock without nominal par value shall be equal to every other share of such stock, except that the certificate of incorporation may provide that such stock shall be divided into different classes with such designations and voting powers or restriction or qualification thereof as shall be stated therein, but all such stock shall be subordinate to the preferences given to preferred stock, if any. Such stock may be issued by the corporation from time to time by the board of directors thereof, pursuant to authority conferred in the certificate of incorporation, or if such certificate shall not so provide, then by the consent of the holders of two-thirds of each class of stock then outstanding and entitled to vote given at a meeting called for that purpose in such manner as shall be prescribed by the by-laws and any and all such shares so issued, the full consideration for which has been paid or delivered, shall be deemed full paid stock and not liable to any further call or assessment thereon, and the holder of such shares shall not be liable for any further payments under the provisions of this chapter. In any case in which the law requires that the par value of the shares

of stock of a corporation be stated in any certificate or paper, it shall be stated, in respect of such shares, that such shares are without par value, and whenever the amount of stock, authorized or issued, is required to be stated, and it shall also be stated that such shares are without par value.

For the purpose of taxes prescribed to be paid on the filing of any certificate or other paper relating to corporations and of franchise taxes prescribed to be paid by corporations to this State, but for no other purpose, such shares shall be taken to be of the par value of one hundred dollars each. But for such purposes of taxation, if any corporation heretofore incorporated with capital stock of a fixed par value shall change its capital stock from a fixed par value to no par value, under the provisions of this section, and shall have paid the organization tax required upon its fixed par value, then no additional organization tax shall be required upon the change of capital stock with a fixed par value to capital stock of no par value; unless, at the time of such change, or any time thereafter, there shall be paid into the treasury of any such corporation, additional capital by the stockholders, voluntarily or under assessment, then the actual amount of such increase shall be reported to the Secretary of State, and the organization tax fixed by law paid thereon. (1934, c. 55, §1; 1926, c. 72, p. 198, subs. 2. Eff. June 14, 1934.)

ARTICLE V.

Railroads

§764. *Amendment of articles; execution and filing of.*— The articles of incorporation may be amended and changed in the manner provided in article one of this

chapter; and a copy of any amendment or alteration, attested by the president and secretary of the corporation, shall be filed in the office of the railroad commissioners and the secretary of state within thirty days after its adoption by the corporation; and when so filed, and a certificate of that fact is delivered to the president or secretary, the corporation shall have the right to make such alterations and changes in its business as are authorized by the amended articles. (1893, c. 171, p. 612, §183.)

§771. *Borrowing and mortgaging to complete or operate road, preferred and common stock; rights of each class.*—Corporations organized under this law shall have power to borrow such sums of money as may be necessary for funding their floating debt or for completing, equipping or operating their road or any part thereof, or for paying any debt incurred for such purpose, and to issue and dispose of their bonds and obligations for any amount necessarily borrowed for such purpose, and to mortgage their corporate property, franchise or any part thereof to secure the payment of any debt contracted or to defray any expenditures for the purposes aforesaid; and may in the manner provided in article I. of this chapter increase or decrease in its capital stock; and the increased stock may be common or preferred as shall be designated in the call for the meeting of the stockholders. If preferred stock be issued the company may guarantee to the holders thereof semi-annual or quarterly dividends, to an amount not exceeding six per cent. per annum payable at its office or at such other places as the directors may designate. The stock may be sold at such time and place, either within or without the state, as may be deemed advisable,

and the proceeds thereof applied for the purposes for which it was issued; the common stock of the company shall be entitled to dividends only out of the surplus of the profits after setting apart a sum sufficient to pay the dividends upon the preferred stock; and the company which issues such preferred stock shall reserve the privilege of redeeming and cancelling same at par at any time after three years from the date of its issue. (1916, c. 46, p. 490, §3, amending 1893, c. 171, p. 612, §190; 1904, c. 105, p. 257, §2.)